IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT.

No. 14,559.

EMIL USIBELLI and ROSE P. USIBELLI,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition to Review the Decision of the Tax Court of the United States.

Brief for Amici Curiae.

JOHN W. BODINE,
Counsel for Jeddo-Highland Coal Company and the Anthracite Institute, Amici Curiae.

Of Counsel:
DRINKER BIDDLE & REATH
117 S. 17th Street,
Philadelphia 3, Pa.,

International, 236 Chestnut St., Phila. 6, Pa.

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anthracite operators. For reasons which are discussed below, many of these anthracite operators hire stripping contractors to load and haul coal to the operators' breakers. Such contracting is also widespread in the bituminous industry, although the contracts used there are not uniformly comparable to the anthracite stripping contracts. Beginning a few years ago, the Commissioner of Internal Revenue took the position that the deduction for percentage depletion allowable to the operators should be reduced by excluding from their "gross income from mining" upon which it was based the amounts paid to their stripping contractors. The Commissioner has not contended, so far as we are aware, that amounts paid to the operators' *employees* should be excluded from the operators' mining income. The Commissioner's position is apparently based on the theory that the contractors (but not the operators' employees) are entitled to a deduction for percentage depletion, but the Commissioner has also (as in the case at bar) denied a deduction for percentage depletion to the contractors. A question of widespread importance has thus arisen, affecting taxpayers throughout the industry. The amount of tax involved to the Jeddo-Highland Coal Company alone, for the tax years for which this question is now in controversy, is over $100,000.

While there have been a number of opinions by the Tax Court in this general area, the only opinion of an appellate court so far was handed down by the Court of Appeals for the Fourth Circuit in the *Gregory* case, discussed at page 32 below. The case at bar is thus the second in this general area to be considered by an appellate court. While the taxpayer here was not a stripping contractor for an anthracite operator, we believe that the case at bar may have a decided bearing on the development of the law in the cases affecting our industry.

In the anthracite cases, we are contending, on behalf of the operators, that in view of the clear language of the statute, the Congressional intent as shown by the legislative

history, and the principles laid down by the decided cases, no deduction for depletion is allowable to the stripping contractors, because they have no depletable interest in the coal, nor any right to any coal in kind as their own, but are merely an adjunct to the *operator's* mining enterprise; and accordingly we contend that the compensation paid to the stripping contractors by the operator should not be excluded from the operator's gross income in computing the amount of the percentage depletion deduction allowable to the operator. In the case at bar, we accordingly support the Commissioner's position and contend that the contractor is not entitled to a deduction for percentage depletion.

Typical Stripping Contracts.

It is because of the analogy between the incidents of the taxpayer's contract in the case at bar and the incidents of the typical anthracite stripping contract that we believe this case may have a decided bearing on the cases affecting our industry. We therefore summarize the incidents of the typical anthracite stripping contract.

Title to the coal. The operator typically owns some deposits in fee and as to others is lessee to exhaustion of the coal, thereby, in Pennsylvania at any rate, acquiring exclusive title to all of the coal in place. *Smith v. Glen Alden Coal Co.* (1943), 347 Pa. 290, 298. The stripping contracts do not provide for the purchase or sale of any coal or other property. They do not contain any words of grant or of conveyance. The contractors get no title of any kind to any coal, do not buy or sell any coal or any interest in coal, and have no right to receive any coal in kind.

Scope of Work. The contractors agree to remove the dirt and rock (commonly known as "overburden") lying above the operator's coal, to load the operator's coal into trucks and to haul the operator's coal to the operator's nearby breaker. On tonnage so hauled to the operator's breaker, the contractors have completed their services and

are thereupon entitled to be paid their compensation by the operator.

After the coal reaches the operator's breaker, the operator processes its coal and delivers the coal to a carrier for shipment to market. The coal is then sold by the operator to the operator's customers, who pay the operator for it. There is no contract or any other relationship whatever between the stripping contractors and the customers. The contractors do not even know, and have no right to know, who buys the operator's coal or how much they pay for it, or whether it is sold at all.

Method of Compensation. The operator pays the stripping contractors for their services rendered at a fixed dollar amount for each ton of the operator's coal uncovered, loaded, and hauled by the contractors to the operator's breaker. Sometimes the rate of compensation per ton of coal fluctuates with the amount of overburden to be removed, and sometimes by reference to changes in certain defined costs of the contractor, but never in the typical case by reference to the market price of the operator's coal.

The sole source of the stripping contractors' compensation is the contractual obligation of the operator (and not of the operator's customers) to pay them for services rendered.

Risk of Market. Because the stripping contractor is typically paid for his services at a fixed rate per ton of coal hauled to the operator's breaker, he is not exposed to a decline in the market price. So long as he strips and hauls the operator's coal as required by his contracts, he has the operator's personal guarantee of payment, even though the operator sells its coal at a loss, or sells its coal and cannot collect, or even does not sell its coal at all.

Discovery. The stripping contractors do not discover the coal and are not hired to do so. In the typical case the extent and quality of the coal to be stripped, and the amount and type of overburden lying over it, have been previously

explored and fully ascertained by the operator, on whom the expense and difficulty of prospecting falls. When the stripping contractor bids on a stripping job, he is furnished with full information as to the borings and other explorations previously conducted by the operator.

Preparatory Work. The stripper must remove overburden before he reaches coal. He sometimes must build temporary roads from the deposit to the breaker. The cost of this work is naturally deducted from the strippers' taxable income, either as it is incurred or on the completed contract basis.

Equipment. The stripping contractor usually furnishes his own equipment, the cost of which is recoverable through depreciation. All of this equipment is movable and not specialized. If not used to strip for one operator, it can be taken to another operator's deposit. The moving may involve expense, but the expense is deductible. The equipment is not even limited to the coal industry. If the operator decides to discontinue a stripping operation, the stripper may contract, for example, to use his equipment in building a highway for the state, or on an excavating job in the construction industry.

Mining Risk. The stripping contractors do not bear the real mining risks. Before they bid on a stripping job, they have the benefit of the operator's full exploration of the deposit. If, despite this exploration, the ratio of coal to overburden should be uncertain, they may contract to be paid at varying rates per ton of coal depending on the varying ratios of coal to overburden which they actually experience. By prudent management they can ordinarily keep their removal of overburden carefully in step with, and not appreciably in advance of, their removal of coal, so that upon finding any unexpected fault in the coal, they can immediately stop any preliminary work on the adjoining section. The stripper is also not exposed to other typical mining hazards. If the stripper is temporarily idle, he

has no heavy maintenance costs; if the idleness should be prolonged, perhaps because of a fault in the deposit, the stripper's equipment, being entirely mobile, and adaptable to many other uses, can be put to productive use elsewhere for others. Consider the very different position of the operator, whose whole enterprise is wholly dependent on an uninterrupted supply of coal, of uniform quality, readily accessible to his immovable plant. Is it reasonable to believe that the contractors, if bearing any serious mining risk, would contract to dig and haul coal for a fixed price per ton?

Termination. Some stripping contracts are terminable by the operator on short notice. Others contemplate that the stripper will work for a year or more and that during that time no other contractor will be permitted by the operator to strip the deposit in question. But the operator customarily retains the right to stop the stripper's work indefinitely. This necessity may arise, of course, from market conditions—if the demand falls off for the operator's coal, the operator cannot keep the stripper working and stockpile coal indefinitely. But other reasons for stopping the stripper may arise, and in a manner showing that it is the operator's mining enterprise in which the stripper's work is but a part—for example, the operator's breaker may have to shut down for repairs, or the underground coal with which the operator mixes the stripped coal may not be available. When it comes to the crucial questions of the quality and quantity of coal to be taken, the operator is typically in command, because in the last analysis it is the *operator's* mining venture in which the stripper is engaged.

Reasons for Contracting. The typical operator has on his lands a variety of deposits. In addition to those far underground he has deposits near the surface, but at varying depths and lying under different types of overburden. Many operators find it uneconomic to keep on hand the dif-

ferent types of equipment necessary for all these different types of surface operations. The contractors, with a variety of movable equipment, adapted to all sorts of different earth- and rock-moving work, can furnish one type of equipment for one stripping job, move to another when that one is completed, or furnish another type of equipment for another type of job. There are operators of course whose deposits are sufficiently uniform so that it is prudent for them to conduct stripping operations with their own equipment and employees. The Commissioner has not suggested that such employees are entitled to depletion, or that the amounts paid to them are to be excluded from the operator's gross income. Why should operators who hire stripping contractors be treated in any different way from operators who strip with their own employees? Neither the contractor nor the employees have any property interest which is being depleted. The depletion is sustained by the *operator* in the extraction of the *operator's* coal, in the course of the *operator's* mining business, and *is sustained by the operator to exactly the same extent regardless of whom the operator engages to do the stripping.*

In summary, in the typical case, the stripping contractors are mere hirelings, engaged to carry out but one of the many parts of the *operator's business* of converting the operator's coal in the ground into a marketable product.

ARGUMENT.

After discussing the applicable statute and the legislative history of the depletion allowance, we propose to show how the principles laid down by the leading cases in the United States Supreme Court and by the Commissioner's Regulations have been applied in the cases in the oil industry which are analogous to the case at bar, and in the cases so far decided by the Tax Court regarding the allowance of depletion to stripping contractors. We contend that the law as developed by the Tax Court has been entirely consistent, both with the Congressional intent, as shown by the legislative history, and with the principles laid down by the leading cases and by the Commissioner's Regulations.

The Statute.

The cases already decided and now pending in the courts on this question all arose under the Internal Revenue Code of 1939. That Code allows a deduction for percentage depletion, based on the "gross income from the property", which is defined in Section 114(b)(4)(B) as the "gross income from mining". In the ordinary case, of course, it is the owner and operator of the mine who admittedly derives the gross income from mining, and the question is whether he must share any of the resulting deduction with any of the contractors who perform services for him.

The statute does make provision for dividing the depletion among two or more parties interested in the same property. Section 23(m) of the 1939 Code deals expressly with three distinct situations:

> (a) "in the case of leases, the deduction shall be equitably apportioned between the lessor and lessee";
>
> (b) where property is "held by one person for life with remainder to another, . . . the deduction . . . shall be allowed to the life tenant"; and

(c) where property is held in trust, the deduction is to be "apportioned between the income beneficiaries and the trustee" in accordance with the trust instrument, or, if it is silent, then "on the basis of the trust income allocable to each".

The case at bar, however, does not involve a lease to the contractor, a life tenancy, or a trust. It is perfectly clear that while Congress did expressly consider the possibility of a division of the allowable deduction, the statute definitely does not authorize such a division where the owner of the deposit hires an independent contractor to dig, haul, and load the owner's coal. The intention of Congress not to allow a deduction for percentage depletion to independent contractors who merely perform a service in respect to another's coal is shown by an amendment adopted in 1950, stated by the Senate Finance Committee to be declaratory of pre-existing law (1950-2 C.B. p. 522). Pursuant to this amendment, if the ordinary treatment processes are carried on at a distance from the mine, not exceeding 50 miles in the ordinary case, Section 114(b)(4)(B) as so amended provides that the term "mining" is to include the "transportation of ores or minerals (*whether or not by common carrier*) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied" (emphasis supplied). Apparently 50 miles was considered the normal maximum distance from the deposit to such plants. The significant feature of this amendment for the present case, in addition to the Committee's statement that it is merely declaratory, is the fact that even though one of the portions of the entire process of obtaining marketable coal is performed by an independent contractor—in the case of transportation, by a common carrier—nevertheless it is the intention and express direction of Congress that the amounts paid to that contractor are not to be excluded from the gross income upon which the *operator's* percentage depletion is to be computed, and conse-

quently that the contractor should not be entitled to any deduction for percentage depletion.

The Legislative History.

A brief review of the legislative history will show that percentage depletion was the natural outgrowth of the earlier methods of computing depletion, and was intended as a more practical and equitable substitute for them, to accomplish the same results, for the same taxpayers, as those to whom the earlier types of depletion were allowable.

The early Revenue Acts allowed the *cost* of the coal in place to be recovered over the expected life of the mine, and where the mine had been acquired before 1913, allowed the *value on March 1, 1913* to be so recovered. But as the true extent and quality of a mineral deposit are often hidden until they are explored, and as one of the objects of the depletion allowance has been to encourage prospecting, especially in war time, the Revenue Act of 1918 permitted depletion to be deducted by reference to the value of the property "at the date of *discovery*". The purpose was thus stated by Secretary of the Treasury Snyder (Hearings, Ways and Means Committee, Revenue Revision of 1950, p. 51):

> "Allowances in excess of cost depletion were first granted in the form of discovery depletion in 1918 as a measure to stimulate mineral exploration for war purposes and to lessen tax burdens on small-scale prospectors who made discoveries after years of fruitless search. Discovery depletion deductions allowed the discoverer of any new mineral deposit to retrieve not only his costs but also the materially larger appreciated value of the property at the time its profitability was established."

The application of these methods of computing depletion led in practice, however, to serious inequities and ad-

ministrative problems, arising principally out of the difficulty of arriving at a fair present value of a mineral deposit, which depended in turn on many assumptions as to the size and quality of the deposit, and the demand for the mineral, rate of profit in mining it, and the fair return on risk capital over the many future years of the operation of the deposit. As early as 1919 certain officials in the Bureau of Internal Revenue became interested in percentage depletion, which had already been adopted in Canada. They proposed to determine the *average percentage* of the gross or net income from each type of mineral deposit which was in fact being allowed under the methods then in use, and to allow depletion to all taxpayers extracting each type of mineral at the average percentage so determined for that particular mineral. In addition to treating all taxpayers alike who mine the same mineral, this proposal had the great merit that it was keyed to the actual results of exploiting the deposit over the years, instead of depending on the many assumptions as to the size and quality of the deposit and its future earning power involved in the other methods. And yet—and this is the significant feature of the proposal from the viewpoint of the case at bar—percentage depletion was intended as a vastly simpler procedure for producing the same results and for the same reasons as the methods previously in use. As Chief Justice Hughes stated, in *Helvering v. Bankline Oil Co.,* (1938) 303 U. S. 362, at p. 367: "The granting of an arbitrary deduction in the case of oil and gas wells, of a percentage of gross income was in the interest of convenience and in no way altered the fundamental theory of the allowance."

Percentage depletion was first applied by Congress in the Revenue Act of 1926, to oil and gas wells. After the submission to the Joint Committee on Internal Revenue Taxation of a thorough report on the subject by L. H. Parker, in September 1929 (see Reports to the Joint Committee, Volume I, part 8), percentage depletion was ex-

tended to metal mines, including coal, by the Revenue Act of 1932.

In the years since 1932, the Congressional Committees have several times reviewed the methods of computing allowable depletion, but after taking testimony from those most familiar with their operation, have made no change in the basic principles governing percentage depletion.

The testimony [1] has referred, first, to the highly speculative character of most mining ventures, the difficulty and expense of finding the deposits, and the loss of investment in many supposed deposits for each that turns out profitably. In addition the fact that mineral resources are ordinarily underground introduces special hazards into mining operations, from floods, cave-ins, and other consequences of the difficulty of controlling conditions beneath the surface. These conditions also increase the cost of maintaining an idle mine during slack periods. The fixed location of the deposits means that the mining concern cannot choose the most favorable site for its operation, having regard to freight rates, accessibility to markets and labor supply, and other cost factors, but must go where the deposit is, whatever the cost. The raw materials used by a mining concern, unlike those of a factory, are usually acquired many years before they are processed, and the capital invested in them is thus tied up for long periods. Further, the experience of coal operations over the years has been one of feast and famine, of wide fluctuations both in the quality and in the quantity of marketable coal.

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1. See, for example, Hearings, Ways and Means Committee, Revenue Revision of 1942, Statements of D. A. Callahan, pp. 1168-1186; R. D. Campbell, pp. 1188-1194; Evan Just, pp. 1203-1206; J. D. Battle, pp. 1210-1213; Hearings, Finance Committee, Revenue Revision of 1942, Statements of D. A. Callahan, pp. 1389-1399; R. D. Campbell, pp. 1399-1405; Hearings, Ways and Means Committee, Revenue Revision of 1950, Statements of D. A. Callahan, pp. 348-362; National Minerals Advisory Council appointed by the Secretary of the Interior, pp. 364-371; Taxation Committee of National Bituminous Coal Advisory Council, pp. 388-407; R. D. Campbell, pp. 407-413; J. W. Haley, pp. 464-469; R. Y. Moffat, pp. 470-471.

The question now arises: is it consistent with the foregoing history for a contractor such as the taxpayer in the case at bar to be entitled to percentage depletion? Are the incidents of this contractor's operations truly comparable to those upon which percentage depletion was originally based and upon which it has subsequently been maintained in the law?

The method based on March 1, 1913 value is obviously inapplicable. So far as the cost method is concerned, it is clear that if the contractor had paid anything for some interest in the coal, he would have a cost which, upon allocation to the recoverable tonnage, would be allowed as depletion. But the Tax Court has made no finding that the contractor here paid anything for any interest in any coal; indeed, it is clear that, like the typical stripping contractor, he did not acquire any interest in any coal whatever.

Would the contractor be entitled to depletion on the basis of discovery depletion? The Tax Court has made no finding in the case at bar that the contractor here did any prospecting; and in the typical anthracite case, the stripping contractor would clearly not be entitled to discovery depletion, by reason of the significant circumstance that he does not discover the coal. The value of the deposit on discovery is not his concern, as it is not his deposit, he being engaged only to uncover it and haul it to the processing plant. The reasons which led Congress to enact discovery depletion—the desire to encourage prospecting, the desire to measure return of capital from the value of the taxpayer's deposit as determined upon *that taxpayer's* discovery of the deposit—these reasons would be wholly inapplicable to the stripping contractor.

Are the reasons upon which Congress has relied in extending percentage depletion to the coal industry applicable to the contractor here? This contractor, unlike the typical operator, is not at the mercy of the market, as the coal here is never to be sold. Can the contractor here, like the stripping contractor, move to another location if

the coal turns out to be faulty? Can the contractor here, like the stripping contractor, leave the coal industry altogether and do road building for the highway department or excavating for a builder? If so, the aspects of the mining business presented to Congress as grounds for continuing the percentage depletion deduction would be inapplicable to the contractor here.

What then would be the result of allowing a deduction for percentage depletion to a contractor such as the one at bar? It would extend the deduction, without any statutory authority, to taxpayers, like this contractor, who could not possibly have claimed it under the previous provisions for which percentage depletion was merely a substitute. It would lead to excluding the payments by the operator to his stripping contractor from the gross income on which the operator's depletion is computed. It would read into the statute a provision for such exclusion, when no such provision exists. It would lead to treating operators who strip with their own employees and equipment in an entirely different way from those who hire stripping contractors, without any statutory authority or sensible reason for such an arbitrary distinction.

Such a construction would stretch the statute not only beyond its clear provisions, but also beyond its established purpose.

The Leading Cases Emphasize That Depletion Is Allowable to One Who Has an INTEREST in the Mineral IN KIND, and Not to One Who Derives a Mere Economic Advantage from Production.

An analysis of the leading decisions of the United States Supreme Court dealing with the division of depletion between several taxpayers interested in the same mineral deposit will show that the rights of the participants in such properties to whom depletion has been allowed by the Court were materially different from the rights of the typical

stripping contractor, and, we submit, from the rights of the taxpayer in the case at bar, as found by the Tax Court.

In *Lynch v. Alworth-Stephens Co.,* 267 U. S. 364 (1925), in holding that a lessee of an iron mine who subleased it to another was nevertheless entitled to depletion, the Court stressed the substantial rights in the ore in place granted by the lease to the taxpayer, including "the valuable right of removing and reducing the ore to ownership".

In *Palmer v. Bender,* 287 U. S. 551 (1933), where the Court first stated the "economic interest" principle, the taxpayer, as lessee of oil land, assigned to another the right to extract and sell the oil, reserving the right to future payments of agreed fractions of the oil produced, payable *in kind.* The Court allowed depletion to the taxpayer, saying, at p. 557:

> "It is enough if by virtue of the leasing transaction *he has retained a right to share in the oil produced.* If so, he has an economic interest in the oil in place, which is depleted by production." (Emphasis supplied.)

In the first Supreme Court case applying these principles to percentage depletion, *Helvering v. Twin Bell Oil Syndicate,* 293 U. S. 312 (1934), the depletion was similarly divided between those who shared the production *in kind.*

On the other hand, in *Helvering v. Elbe Oil Land Development Co.,* 303 U. S. 372 (1938), where the taxpayer assigned his lease for cash and a share in the net profits to be obtained by the assignee from production, the Court held that no interest in the oil in place had been retained, and the taxpayer was accordingly not entitled to depletion.

And in *Helvering v. O'Donnell,* 303 U. S. 370 (1938), rehearing denied, 303 U. S. 669 (1938), the taxpayer assigned to another his stock in a corporation owning oil and gas properties, in consideration of the assignee's agreement to pay one-third of the *net profits* from operations. The taxpayer was denied any deduction for depletion, as his ownership of stock did not constitute an interest in the oil

and gas in place, and the personal covenant of the assignee carried with it no interest in the properties or their output. The taxpayer obtained an "economic advantage from the (assignee's) operations," the Court said, "but that advantage or profit did not constitute a depletable interest in the oil and gas in place."

The retention of an interest in the net profits does not bar the deduction, however, where the taxpayer also retains other *substantial* interests in the mining deposits. For example, in *Kirby Petroleum Co. v. Commissioner,* 326 U. S. 599 (1946), the taxpayer leased oil land for an oil royalty payable in kind and a share in the lessee's net profits. It was held that, in the light of the substantial economic interest reserved by the taxpayer in the oil in place by virtue of the royalty *payable in kind,* there was a sufficient economic interest also in the oil to support percentage depletion to the taxpayer on the share in the net profits received.

And in *Burton-Sutton Oil Co. Inc. v. Commissioner,* 328 U. S. 25 (1946), the taxpayer operated certain oil lands as the ultimate assignee of a series of assignments of the basic lease. The taxpayer was required to pay to one of the previous assignors one-half of the taxpayer's net income from operations. It was held that although the assignor-payee had never been the owner and was merely an assignee in the chain of assignments, and although the assignor-payee received only a share of the net income, nevertheless the additional substantial rights retained by the assignor-payee showed that he had reserved an "economic interest" in the oil, so that payments to him by the taxpayer were not only to be excluded from the taxpayer's taxable income, but also from the taxpayer's "gross income from the property", for purposes of computing the percentage depletion to which the taxpayer as producer was admittedly entitled. Cf. the Tax Court's opinion on remand, 7 T. C. 1156. The valuable rights so retained and so distinguishing the situation from that in the *Elbe Oil Land* case were the right to require prompt drilling, the right to require an accounting of production, and the *right to buy all the oil produced on*

specified terms if desired. These rights, however, are far more extensive and give a far greater interest in the economic potential of the mineral deposit than the closely restricted rights of the contractors, such as the taxpayer in the case at bar, who have no right to insist that any particular quantity of coal be produced, promptly or otherwise; who have a right only to be paid the agreed rate on the tonnage of the owner's coal which they turn over to the owner; and who have no right to buy any of the coal produced.

In *Helvering v. Bankline Oil Company,* 303 U. S. 362 (1938), the Court denied percentage depletion to a processor of oil products, despite his control over their sale. There the taxpayer operated a plant for the extraction of gasoline from wet natural gas. The raw gas was supplied to the plant from wells controlled by a number of separate operators. The taxpayer took title to the gas at the mouth of each well and paid for the right to process the raw gas by handing over to the producer one-third of the gasoline and by-products derived from the taxpayer's process. It was held that the taxpayer in that case was not entitled to percentage depletion, because, although he derived an economic advantage from the production, he had no capital investment in the gas *in place.* He had a right to receive any gas produced, but he could not compel its production. Chief Justice Hughes put the principle in a nutshell when he said, at p. 367:

> "The phrase 'economic *interest*' is not to be taken as embracing a mere economic *advantage* derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit." (Emphasis supplied.)

Similarly the stripping contractors perform merely one of the steps in the total operation of extracting and processing the operator's coal into a marketable product, and, although deriving an economic *advantage* from performing their

portion of the work, have no capital investment in the coal in place. They have no right to compel continuance, even in their part of the process, if the operator chooses at any time not to take its coal in at its breaker. They have at most, as did the taxpayer in the *Bankline* case, the right to insist that if anybody is to perform their particular part of the total processing of the material, they are to be the ones to do it. And unlike the processor in the *Bankline* case, the strippers have no right to keep and sell for their own account any part whatever of the natural resource itself. Similarly the taxpayer in the case at bar, while possibly processing the coal farther than the typical anthracite stripper, had no capital investment in the coal in place, which remained at all times the property of the Government, and had no right to keep and sell for his own account any part whatever of the coal.

The Commissioner's Regulations.

The principles developed in these cases have been echoed in the section of the Commissioner's Regulations which is most nearly relevant to the present issue:

Regulations 111, Section 29.23(m)-1:

> "The owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. * * * An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any *interest in mineral in place* or standing timber and secures, by any form of legal relationship, income derived from the *severance and sale* of the mineral or timber, to which he must look for a return of his capital. *But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production.* Thus, an agreement between the owner of an economic inter-

est and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest. * * *" (Emphasis supplied.)

How do these principles apply to the stripping contractors? They have not invested any capital in the deposit, their investment being in depreciable equipment. They are hired to sever the operator's coal (among other services to be rendered by them), but they have nothing to do with its sale, nor is their return dependent on the operator's sale of the coal. If the operator should choose to stockpile coal against a period of better demand, the stripper would continue to be paid for his services even though no coal was being sold at all. The fact is that the stripper's capital is returned to him through the use (and therefore depreciation) of his equipment. Such use takes place fully as much in the removal of overburden and the hauling of coal as it does in the severance of coal, and is quite independent of any sale of the coal. The stripper does not have the right to "reduce the ore to ownership," which was the basis of *Lynch v. Alworth-Stephens,* nor the right to receive any coal in kind, comparable to the oil interests payable in kind which were central to the decisions in *Palmer v. Bender, Twin Bell, Kirby,* and *Burton-Sutton.*

The stripper relies, not on any interest in the coal, whether in place or on the market, but on the personal covenant of the operator, who promises to pay him compensation for services rendered. Is not the stripper's situation far more analogous to that of *O'Donnell,* who relied merely on a personal covenant, or to *Bankline,* who, like the stripper, had a "mere economic advantage from production, through a contractual relation to the owner"?

How do these principles apply to the taxpayer in the case at bar? His capital has been invested, not in the coal deposit, but in his depreciable equipment. His capital is

returned to him through the depreciation of his equipment, which occurs not only in the severance of the Government's coal, but also in hauling, processing, and loading it for shipment. He does not have the right to "reduce the ore to ownership", nor the right to receive any coal in kind. He relies for his compensation, not on any interest in the coal, whether in place or on the market, but on his contract with the Government to pay him for services rendered.

To reduce the operator's depletion deduction by excluding from the operator's gross income the amounts paid to the strippers, and to allow the depletion deduction pro tanto to the strippers, or to the contractor in the case at bar, would be to distort beyond recognition the guiding principles developed in the leading cases, and adopted in the Commissioner's Regulations.

Decisions Regarding Independent Contractors in the Oil Industry Have Allowed Depletion Where the "Contractor" Has an Interest in Kind in the Oil, But Not Where He Has a Mere Economic Advantage from Production.

The closest analogy in the oil industry is presented by the cases dealing with the allowance of depletion to taxpayers who own and operate the specialized equipment required for drilling oil wells. Such drillers are ordinarily paid in cash for their services, and ordinarily do not receive any share in the oil itself, and no suggestion appears to have been made in any of the decisions that such a driller receiving cash alone is entitled to depletion. But in the unproven areas, the driller is often paid only a part of his compensation in cash, and in many cases the balance of his compensation is to be paid to him solely out of the oil produced, if any. The driller has substantially completed his work before the productivity of the well is known and thus makes a substantial investment in what is essentially a quite hazardous undertaking, considering that in 1951, for example, according to the American Petroleum Insti-

tute, approximately 16,000 dry holes were drilled in the United States, and that in the unproven areas, to which contracts compensating drillers from a share in the oil are usually confined, the dry holes comprised approximately seven-eighths of all the wells drilled. The anthracite stripper on the other hand frequently starts extracting coal at almost the beginning of his work, and the extent of the coal deposit has been fully ascertained ahead of time by the operator. There are rarely any "dry holes" in coal stripping. There is likewise no finding by the Tax Court in the case at bar that there was any uncertainty as to the extent or quality of the coal deposit here. Furthermore, the anthracite stripper, and the taxpayer in the case at bar, in receiving compensation at a fixed amount per ton regardless of the market price, are in an entirely different position from the driller who derives a substantial part of his compensation from his *share in the oil* produced, with its attendant risks and benefits from changes in the market price. In the light of the leading Supreme Court cases referred to above, upon which the drillers' cases expressly rely, the crucial significance of this method of compensation is evident.

The leading case dealing with such drilling contracts is *Dearing v. Commissioner,* 102 F. 2d 91 (C. A. 5th 1939). There it was held, following *Palmer v. Bender, supra,* that as the driller had not deducted his drilling costs as business expenses in the year of drilling, but had capitalized them to the extent not reimbursed by the small cash payment on completion of the drilling, and as he was to be further compensated, not under any personal obligation of the operator, but from the interest in the oil *in kind* reserved by the driller, he had thereby obtained an economic interest in the oil in place. Accordingly, the share received by him from the sale of oil during the taxable year was subject to percentage depletion. But the contractor *is* compensated by virtue of the owner's personal obligation, and *not* from any share in the coal reserved to the contractor. Further,

the basic difference in the factual situation was highlighted here by the fact that the driller was still receiving his compensation on his lucky strike in this case *several years* after his services were *completed*—a situation which would be unthinkable in coal stripping operations or under the Government contract in the case at bar.

Similarly in *Spalding v. U. S.*, 97 F. 2d 697 (C. A. 9th 1938), *cert. denied* 305 U. S. 644 (1938), the taxpayer, as lessee, engaged an oil company to *drill and operate* the wells for *fifteen years* and turn over the oil to the taxpayer for sale, the oil company however to receive about 60% of the proceeds of such sale. It was held that both the taxpayer and the oil company had depletable economic interests in the wells, and that the taxpayer could deduct depletion by reference to only one-third of the gross income from the wells, that being her share of the oil in kind. The Court dismissed the argument that the oil company did not have a depletable interest as follows (97 F. 2d, at p. 700):

> "Though referred to in the agreement as a 'contractor,' the Oil Company was not, as contended by appellant, a mere contractor for hire. It had the right to, and did, occupy the leased property and produce oil and gas therefrom. It had the right to, and did, receive and retain as its own 61⅔% of the net proceeds of the oil and gas so produced. These were continuing rights which, except for non-performance of the agreement by the Oil Company, were not terminable by appellant until 1944. The possessor of such rights cannot be regarded as a mere hireling."

By this test, however, the anthracite stripping contractors would clearly be mere "hirelings." They have no exclusive possession of the property, but are merely permitted to come on it to perform their services. They do not produce a saleable product, but merely haul the operator's raw coal material to the operator's breaker for processing. They have no right to, and do not, retain as their own any share whatever of the coal or of the proceeds of its sale by the

operator. They are engaged to perform a specific, limited service, without any rights whatever in the coal itself, and as such they are mere contractors for hire. Similarly the taxpayer in the case at bar was engaged to perform a specific service, with no right to retain any coal for himself, and as such is merely a contractor for hire.

These principles were recently further illustrated in the opinion of Judge Disney in *Roeser & Pendleton, Inc.*, 15 T. C. 966 (1950), aff'd. sub nom. *M-B-K Drilling Co. v. Commissioner* (C. A. 10th 1952), 194 F. 2d 221. There a driller contracted to drill certain wells "at the prevailing rate in the field . . . for similar work performed by independent contractors." As each well was finished, the driller was to be paid his cash outlay on that well, and the balance of his compensation was to be paid in monthly instalments, "each such payment to be . . . not less than fifty percent of the operator's net income" from the well, the payments to begin after the well "had fully paid out." Judge Disney construed this to mean that the driller was to be paid for his services in all events. His opinion states, at p. 971:

> "It is not reasonable to believe that the petitioner would have drilled for the usual rate prevailing in the field and at the same time have taken a chance on oil production for its payment. We have no doubt that had there been intent to take such a chance, the drilling price would have been more than the usual rate. Though there were to be monthly payments deferred until the 'payout' of the properties of the operator, there was provision for continuation of payments until the 'account payable' was 'fully discharged,' from which we believe that the principal thought involved was the deferment of liability until the operator's other costs were fully paid out and that in the absence of any provision that payment should be limited to the oil or proceeds, M-B-K would have had a right to a

> reasonable monthly payment even after oil production had ceased until the account was paid up."

The Tax Court therefore held that, as the driller's compensation was based on the personal obligation of the operator, and not on any interest in the oil in place, the driller did not acquire an "economic interest" in the oil and therefore would not have been entitled to a deduction for depletion. It will be noticed that this driller, like the stripping contractor, was held to have assumed none of the risks assumed by the wild-cat driller in consideration of an in-oil payment. The contractual relationship in the *Roeser & Pendleton* case was aptly summarized as follows, at p. 973:

> "[The operator] could have paid [the driller] out of any funds available to [the operator], and the monthly payments while there was oil production would be merely measured thereby."

Like the driller in *Roeser & Pendleton,* the anthracite strippers are contractors for hire, engaged to render specified services for the operator, in uncovering, loading, and hauling the operator's coal to the operator's breaker, but without themselves having any rights in that coal. The operator is personally obligated to pay for these services, regardless of whether that coal is or is not further processed and sold. The operator must pay for these services out of any funds available to the operator. The fact that the payments are measured by the quantity of the operator's coal hauled to the breaker is no more controlling than it was in *Roeser & Pendleton.* Similarly the taxpayer in the case at bar is engaged to extract, grade, and load the Government's coal, without himself having any rights in that coal. The Government is obligated to pay for those services regardless of the disposition of the coal, and the fact that payments are measured by quantities of coal shipped is immaterial.

The driller in *Roeser & Pendleton* played an important part in the extractive process; he was the first to come in contact with the oil in place; he apparently completed the well, with the oil ready to flow; but, like the strippers and the taxpayer here, he looked for his compensation to the personal obligation of another, and not to the mineral itself; and for this reason, equally applicable to the strippers and to Usibelli, he had no "economic interest" in the mineral.

Cases Arising in the Mining Industry Have Consistently Held That, Under a Contract Such as the One Before This Court, the Contractor Does Not Have a Depletable Interest in the Coal.

Twelve cases have so far been decided by the Tax Court on the general question here in issue. None of the judges of the Tax Court has dissented in any of these cases. In deciding which contractors have a depletable interest in the coal and which do not, the Tax Court, in a manner fully consistent with the authorities cited above, has first taken into consideration all of the incidents of the contracts. Those contracts which give the contractor extensive rights and duties in connection with the mining of the coal, and under which he must assume risks of the market and otherwise, have been held to give the contractor an interest in the coal entitling him to a deduction for percentage depletion. But those contracts which limit the role of the contractor to uncovering, loading, and hauling coal, when and as coal is needed by the operator, which do not expose him to the risks of a fluctuating market price, and which make his compensation the personal obligation of the operator, have been consistently held not to give the contractor an interest entitling him to percentage depletion. We submit that these cases have been correctly decided, that the line drawn by the Tax Court is practical and consistent with the authorities, and that this Court should hesitate to dis-

turb a principle carefully thought out by the Tax Court and found to be workable in such a considerable number of cases.

The first of these decisions by the Tax Court was *Morrisdale Coal Mining Co. v. Commissioner* (Judge Rice, November 12, 1952) 19 T. C. 208; ~~*on*~~ *appeal* to C. A. 3d [illegible] Although the taxpayer in that case was a bituminous operator, the incidents of the stripping contractors' relationship to the operator were substantially similar to those set forth above as typical in the anthracite industry. The contractors received a stated amount per ton of coal hauled by them to the operator's tipple, which sum was independent of the market, and the operator's obligation to pay arose when the coal was hauled to his tipple by the contractors regardless of whether or when the operator sold the coal. The contractors received no payment in coal and had no right to sell any coal to other parties. The amount of coal to be mined by them was entirely dependent upon the operator's demands. The Tax Court held that the contractors had no economic interest in the coal, and were not entitled to depletion, and that therefore the payments made to them by the operator should not be excluded from the operator's gross income in computing the operator's depletion.

It is important to note that the Tax Court, in determining whether the contractor had an "economic interest" in the coal, first looked—as it was required to do under the leading cases—to all the incidents of the contract, and on those incidents based its conclusion that the contractor did not have an "economic interest". The right of the operator, for example, to control the quantities of coal to be hauled by the contractor to the breaker is one of the factors indicating that the contractor was a mere hireling, performing a step in the operator's business at the operator's beck and call. It would be begging the question to say, as contended at pp. 11 ff. of the Amicus brief filed here for the stripping contractors, that the contract gave the con-

tractor an "economic interest" and that therefore the fact that the operator can control the quantity of coal hauled by the contractor is immaterial. The operator's control over the quantity of coal hauled is an essential feature of the contract, which must first be considered before it can be decided whether the contract does or does not confer an "economic interest" on the contractor.

In *James Ruston* (Judge Hill, November 21, 1952), 19 T. C. 284, *appeals by taxpayer and Commissioner to C. A. 4th dismissed without opinion on parties' stipulation,* 1953 P. H. Fed. Tax Service, para. 71,153, the Tax Court, again looking to all the incidents of the stripping contractor's rights and duties, found that the stripping contractor there not only supplied the necessary stripping equipment and built the necessary roads, but also maintained and operated the tipple, and processed, cleaned, and shipped the coal at its own expense. The Tax Court construed the contract as providing, not that the contractor was to be paid a fixed rate for coal shipped, but rather that the contractor was to be paid a percentage (83%) of the net selling price from coal sold, a vital distinction in the light of the authorities. It is important to realize that the sharing of sales realization was not relied upon as the *sole* test of who is entitled to depletion. In the light of the leading cases, *supra,* and of the Commissioner's Regulations, however, the deriving of income from the severance *and sale* of the mineral certainly is significant, and could hardly be more dramatically shown than by an agreement compensating the stripper by a direct percentage in the realization. The Tax Court also relied on another factor—very significant in the light of the *O'Donnell* and *Bankline* decisions—that the contractor looked for its compensation to the sales proceeds and not to the personal obligation of the taxpayer. Another significant factor in the *Ruston* case is the contractor's very considerable participation in the entire mining process—operating and maintaining the tipple, and sizing, cleaning, and shipping the coal. This participation was far more

than the typical anthracite contractor's role of merely uncovering, loading and hauling coal, which in the ordinary case is a mere portion of a complex prospecting, extracting, processing, and marketing business carried on and dominated by the operator. The stripping contractor in the *Ruston* case obviously had a stake in the coal itself, and the Tax Court accordingly held that the contractor in that case was entitled to percentage depletion.

While the Tax Court in the *Ruston* case thus relied on a variety of factors, it was the sharing by the contractor directly in the sales proceeds which was most frequently referred to. There are several reasons for the significance of this provision. A contractor who shares in the sales realization cames more clearly within the requirement of the leading cases, *supra,* and of the Commissioner's Regulations, that to have an "economic interest" one must derive income from the severance *and sale* of the mineral. It is hard to see how a contractor who is paid for hauling coal which may never be sold can derive income from its *sale.* Further, a contractor who shares in the sales proceeds takes the risk of the market, and his chance of profit is tied much more intimately to the rise and fall of prices and to the fluctuations of demand than would be the case if he depended solely upon the contractual obligation owed to him by the operator. Fundamentally, the significance of sharing in the sales proceeds derives from the circumstance that while a deduction can only be allowed to a taxpayer for the depletion of *his coal,* the question as to what is his coal must be decided, not so much by the niceties of legal title, nor by the question whether he is an employee or an independent contractor, but rather by the very practical economic tests of businessmen. We submit that the Tax Court has correctly held that where a contractor merely loads and hauls coal for a fixed sum guaranteed by the operator, who must pay whether the coal is sold or not, the contractor has only a limited business interest in the coal—indeed, he might as well be hauling rocks; but where

the contractor's profit depends directly on whether the coal is sold and if so, for how much, then he is clearly in the business of mining and selling *coal* for his own account and for that reason is sufficiently involved in an economic sense to be entitled to a part of the depletion deduction. Many of the cases cited in this brief (e.g. *Palmer, Twin Bell, Kirby,* and *Burton-Sutton*) speak of an interest in the natural resource *in kind* as an important test of the right to deduct depletion. We believe that a contractor who is paid by reference to a percentage of the sales price may thereby be said to have an interest in the coal *in kind* and that such a right to share in the proceeds of sale, far from being irrelevant, as contended at pp. 4 ff. of the Amicus brief filed here for the stripping contractors, is a significant indication of a depletable interest. This principle was thus stated in *Eastern Coal Corp. v. Yoke,* 67 F. S. 166, at p. 175:

> "The courts have repeatedly held that rights to share in the gross proceeds derived from the sale of the mineral produced are analogous to rights to share in the mineral produced. It follows that one who has a right to a share of the proceeds from the sale of coal produced has ownership of a corresponding depletable economic interest without regard to conveyancing formalities."

The *Morrisdale* and *Ruston* cases, decided within a few days of each other, thus illustrate the circumstances under which a contractor is or is not entitled to depletion.

In the following cases the Tax Court found that the facts brought the situation within the *Morrisdale* case:

Mammoth Coal Company (Judge Le Mire, reviewed by the Court, June 16, 1954) 22 T. C. 571.* The contractors looked only to the personal obligation of the operator and had no right to any coal in kind; their compensation did not vary with the market price; the operator could control the quantities of coal to be stripped by the contractors.

* on appeal to C A 3d

The agreements of some of the contractors, but not all, were terminable at will by the operator.

C. A. Hughes & Co. (Judge Withey, March 9, 1955) 14 T. C. M. 172, #20,893 (M); the stripper's contracts were found to be terminable by the operator on short notice.

Hamill Coal Corporation (Judge Withey, March 23, 1955) 14 T. C. M. 218, #20,924 (M). The contractor looked only to the operator for payment and had no right to any coal in kind; the contractor's compensation did not vary with the market price; the operator controlled the stripping operations and could reduce the quantity of coal to be stripped by the contractor; the contractor's investment in equipment was immaterial, as the equipment was movable and adaptable to other ventures.

Weirton Ice & Coal Supply Co. (Judge Bruce, June 10, 1955) 24 T. C. No. 40. The contractor was paid by reference to his costs and not by reference to any sales price; the contract could be terminated by either party on short notice; the contractor furnished all equipment and loaded, hauled, and processed the coal; the operator did not direct the manner of carrying out the operation; the contractor's investment in equipment was immaterial, as it was adaptable to other uses and subject to a deduction for depreciation. The fact that the contractor had other lands on which it mined coal for its own account was also immaterial. "The discretion and independence which is allowed an independent contractor in the performance of his services and the similarity between those services and the conduct of like operations on the contractor's own lands have no bearing upon whether the contractor has an economic interest in the *coal which he is extracting for another*" (emphasis ours).

In the three following cases the Tax Court found that the facts brought the situation within the *Ruston* case:

Helen C. Brown (Judge Murdock, April 13, 1954) 22 T. C. 61. The contractor had "the exclusive right to mine the coal . . . and was to be paid a percentage of the

amount of the gross sales." The taxpayer's payments to the contractor were therefore to be subtracted from the taxpayer's "gross income from the property".

Winfield Mining & Contracting Co. (Judge Murdock, June 25, 1954) 13 T. C. M. 571, #20,416 (M). The contractor extracted the coal, hauled it to the tipple, processed and shipped it; the contractor's compensation rose automatically with the market price; the sales agent sent orders directly to the contractor; the contractor had the option to buy the underlying lease if taxpayer sold it; the taxpayer had no employees and comparatively minor expenses; the contractor had "the exclusive right to mine coal, without interference" from the taxpayer, and the contractor had "the entire responsibility for and expense of production, and had to look solely to the sales for payment."

Paul E. Barry, Inc. (Judge Raum, January 24, 1955) 14 T. C. M. 37, #20,825 (M). The contractor assumed the risk of the enterprise, did its own prospecting for coal, was compensated by reference, among other factors, to the sales price, and had the right to, and did, sell to its own customers coal not taken by the operator.

In *Emil Usibelli* (Judge Murdock, June 30, 1954) 13 T. C. M. 602, #20,440 (M), the case now before this Court, the facts are unusual in that the taxpayer is a contractor hired by the United States Army to extract, grade, and load coal from deposits owned by the government for use by the Army. As the coal was never sold, the contractor's compensation was determined exclusively by reference to his costs. The quantities of coal to be taken could be reduced by the government if its requirements changed. The contractor "was paid an agreed amount for the work which he performed," and was held not to have an "economic interest" entitling him to depletion, following *Morrisdale.*

A pair of Tax Court decisions are significant because they are the only ones on which an Appellate Court has so far handed down an opinion. In *J. E. Vincent, et al.* (Judge Arundell, December 24, 1952) 19 T. C. 501, one of

the contractors (Summit Fuel), who was stated in the contract to be engaged in a "joint adventure" with the operator, had the obligation to process the coal and load it for shipment, and the right to take for its own account coal uncovered but not extracted upon termination of the contract by the operator. It was not to be paid by reference to the selling price, and looked to the operator for its compensation. Another contractor (Swaney) was to load and haul coal but not to process it, its work could be curtailed by the operator, and it looked to the operator for its compensation, but it was paid by reference to the market price. The facts of the *Vincent* case were thus somewhat confused and did not fall readily on either side of the line originally drawn by the Tax Court between the *Morrisdale* and *Ruston* cases. In any event the Tax Court decided for Vincent, holding that the contractors were not entitled to depletion and that the amounts paid to them should accordingly not be subtracted from the taxpayer's "gross income from the property" on which the taxpayer's depletion was computed. Subsequently in *B. H. Swaney & Sons, Inc.* (Judge Van Fossan, December 4, 1953) 12 T. C. M. 1371, #20,020 (M), the Tax Court, following its decision in *Vincent,* held that Swaney, who was one of Vincent's contractors, was not entitled to depletion.

The Government thereupon appealed the *Vincent* case to the Fourth Circuit, contending that the amounts paid to the contractors should be subtracted from Vincent's gross income for depletion purposes. Swaney also appealed to the Fourth Circuit, contending that it was entitled to depletion. The cases were argued together, as the dispute was primarily between Vincent and Swaney. The Court of Appeals for the Fourth Circuit, in an opinion entitled *Com'r v. Gregory Run Coal Co.* (April 9, 1954) 212 F. 2d 52, vacated the Tax Court's orders in both cases and remanded both cases. Vincent's petition for certiorari was denied, 348 U. S. 828. The opinion of the Court of Appeals relies almost exclusively on the *Burton-Sutton* decision, discussed

supra at p. 16; but the Court in *Gregory* seems to have been under the impression that the *Burton-Sutton* case dealt with "the right of the producer of the oil to a depletion allowance"; whereas in that case no one doubted the *producer's* right to depletion, as the issue there involved his *assignor's* right to depletion. The Court in *Gregory* seems to agree with us that an interest in the coal in kind is an indispensable ingredient in the right to depletion, setting forth at length the Supreme Court's language to that effect in *Burton-Sutton,* and singling out the statement in *Eastern Coal Corp. v. Yoke,* 67 F. S. 166 (the only other precedent mentioned in the *Gregory* opinion) that "one who has a *right to share in coal produced* also has a corresponding interest in the coal in place" (emphasis ours); but the Court in *Gregory* does not make clear which factors it considered gave the contractors a right to share in the coal. This might have been deduced from the facts that one contractor (Summit), though paid a flat price, was considered as mining "jointly" with the operator and had the right to take for its own account coal uncovered but not extracted on termination by the operator, and that the other contractor (Swaney) was paid by reference to the market price; but if this was the Court's reasoning, it does not clearly say so. The Court does state that the possibility of profit to the contractors was "dependent solely upon the extraction *and sale* of the product" (emphasis ours). The Court recognizes that a hireling who merely performs the labor of production for a fixed sum is not entitled to depletion; but concludes that the strippers before it were entitled to depletion because their rights "were completely dependent upon the extraction of the salable product." But would not the hireling's rights be dependent on such extraction also? Depletion would be allowable to every miner in the mine if dependence on extraction were the test. The *Gregory* opinion can thus hardly be considered as a thoroughgoing review of the authorities on this important question. We submit that the facts in the *Gregory* case, as

construed by the Circuit Court, are distinguishable from those in the case at bar, and in the typical anthracite stripping case, and that the Circuit Court's discussion of the principles involved is not sufficiently enlightening to be persuasive here.

After the Fourth Circuit's decision in the *Gregory* case, the next decision by the Tax Court on this question was in *Mammoth Coal Company,* discussed at page 29, *supra.* The Tax Court considered the *Gregory* decision and held that that case was distinguishable from the *Mammoth* case. The Tax Court's opinion did not retreat in any way from its position in the *Morrisdale* case. It is significant that this opinion was reviewed by the entire Tax Court and that none of its judges dissented.

Two other decisions, often considered in this connection, are distinguishable on their facts.

The first is *North Range Mining Company,* 46 B. T. A. 296 (1942), in which the Ford Motor Company, as the long-term lessee of an iron mine, turned over to the taxpayer the entire mine with all of its buildings and equipment, for five years. The agreement conferred very substantial rights upon the taxpayer. The taxpayer could fully exploit the mineral deposit and fully control the manner in which that was done. The taxpayer's interest in the ore deposit and the mining facilities was deemed to justify the requirement that the taxpayer should pay the local real estate taxes thereon. The taxpayer was required to deliver to Ford the quantities of ore periodically specified by Ford and was to be paid a fixed price per ton of ore so delivered, with adjustment in the price for changes in labor costs only; but the taxpayer was given the very important right to mine as much additional ore as desired and to sell this ore to vendees of its choice without any limitation as to price, the taxpayer being obliged only to pay Ford a royalty on such ore comparable to the royalty which Ford was obliged to pay to its lessor. That this right was not insubstantial is shown by the fact that the proportion of the total ore mined

by the taxpayer and sold to outsiders increased steadily during the taxable years in issue and amounted in the last such year to over 38% of the total ore mined. The taxpayer even entered into contracts for the sale of ore to outsiders covering a period of years. Thus the taxpayer's rights, not only in the ore to be sold to outsiders but also in that part of the deposit to be used to meet the requirements of Ford, were varied and extensive. The Government had conceded that, as to the ore sold to outsiders, the taxpayer was entitled to depletion, and that the royalty retained by Ford on that ore also concededly entitled Ford to depletion thereon. As to the ore not sold to others, but delivered by the taxpayer to Ford, it was mined by the taxpayer under the same broad powers of management and control, under the same agreement, as the ore sold to others. The Tax Court accordingly refused to treat the two types of production differently, and held that as the taxpayer was entitled to depletion on the one, it was similarly entitled to depletion on the other. If Ford had been required to pay the full market price for the ore delivered to it, and had retained a right to collect a royalty from the taxpayer on that ore, then Ford would have retained a depletable economic interest, the depletion of which would have been measured by that royalty; but as Ford chose to rely solely on the taxpayer's contractual obligation to sell ore to Ford, Ford had no economic interest in that ore in place, and hence was entitled to none of the depletion with respect to it. (It will be recalled that the Regulations deny depletion to a taxpayer having the mere right "to purchase the product upon production".) It followed that the taxpayer was entitled to all the depletion on the ore sold to Ford.

The *North Range* case was followed by *Eastern Coal Corporation v. Yoke,* 67 Fed. Supp. 166 (1946), which was decided by the District Court for the Northern District of West Virginia. An appeal by the Government was at first authorized, but then abandoned (1947 Prentice-Hall Fed-

eral Tax Service, para. 71,056). In that case the taxpayer [2] in 1936 leased certain coal mines from the Fordson Coal Company, subject to a royalty of 10¢ per ton, and agreed to buy from Fordson the equipment and improvements of the mines for $1,235,000. The Government conceded that under this lease the taxpayer had a sufficient economic interest to support a deduction for depletion. Simultaneously with this lease the taxpayer contracted to sell to the Ford Motor Company about 6,000,000 tons of coal at $1.56 per ton. In 1937, Fordson having assigned the lease to the Ford Motor Company, a new agreement was made, under which the taxpayer acquired from Ford a one-eighth undivided interest in all the coal in the leased tract, which taxpayer had the absolute right to extract and market for its own account if mined in the succeeding 15 years. The taxpayer agreed to sell about 5,000,000 tons of coal to Ford from the other seven-eighths interest. Although the 1937 agreement was not called a lease, the full incidents customary in mining leases were conferred upon the taxpayer, including the right to exclusive possession and operation of the property, the right to cut timber, and the duty to pay local taxes. The 1937 agreement provided that the taxpayer would receive $1.46 per ton for the coal which it contracted to deliver to Ford, and that it would not be required to pay to Ford any royalty on the coal so delivered. The contract permitted adjustment for changes in labor costs only. The Court held that the taxpayer had the status of a lessee as to the other seven-eighths interest. It will be noticed that here also the rights of the taxpayer were far more extensive and varied than those customarily enjoyed by the stripping contractors. The parties had originally given the taxpayer the interest of a lessee, and the changes in the agreement

2. The amicus brief filed here for the stripping contractors says (at page 8) that this case involved a "strip-miner". As the published report is not clear, we inquired of George Richardson, Esquire, of Bluefield, W. Va., who represented the taxpayer in that case. He informs us that all of the mining there involved was underground, and that no strip mining was involved.

were so unimportant that that status clearly continued. The taxpayer had full control over a one-eighth undivided interest in the coal, which was sold to customers chosen by the taxpayer and at prices controlled by the taxpayer. On these sales the taxpayer had the risks and benefits of changes in the market price. The taxpayer had full control over the entire mining operation and purchased for over a million dollars the mine buildings and equipment. In view of the substantial rights of the taxpayer in the coal in place the Court could readily extend the principles of the leading cases cited above to hold, following the *North Range* case, that the taxpayer was entitled to depletion on the entire output. As to the one-eighth undivided share, the taxpayer's full power of extraction and sale for its own account gave it an undoubted economic interest; and as to the balance of the coal, the change from a lease requiring the sale of that coal at $1.56 per ton less a royalty of 10¢ per ton, to an agreement under substantially the same terms, requiring the sale of the coal at $1.46 per ton, was so slight as not to justify the disallowance under the agreement of the depletion which had concededly been allowable under the lease.

In both the *North Range* and *Eastern Coal* cases the taxpayers had substantially greater rights than those of the taxpayer in the case at bar. The taxpayer in one of those cases was expressly given an undivided interest in the coal in place, and in both cases the taxpayers had the right to sell a substantial quantity of the coal to vendees and at prices fully controlled by the taxpayers. The contractor here was given no share in the coal, either in place or upon extraction, and had no right to sell any of the coal to anybody. And it is impossible to say that the effect of the contract here is the same as a contract of sale less royalty payments (as in the *North Range* case), since the contractor here does not own anything to sell, and works or not as the Government determines; nor is it possible to say that the effect is the same as a lease (as in the *Eastern Coal* case),

since the contractor here was not found to have any rights of exclusive possession or independent operation, and had no right to sell any of the coal. The situations presented by those cases are fundamentally different from the situation of the contractor in the case at bar.

There remains the decision in *Oliver Iron Mining Company,* 10 T. C. 908 (1948) (appeal by Commissioner withdrawn, 1949 Prentice-Hall Federal Tax Service paragraph 71,141). There the taxpayer, as lessee of a deposit of iron ore, engaged an independent contractor to mine the ore, ship it, and market it. From the sales proceeds the contractor was to pay all the expenses of operation; to pay the royalties due to the lessor and the local taxes, for which the taxpayer remained liable; to retain four cents per ton of ore for its services; and to pay over the entire balance of the proceeds to the taxpayer. The Tax Court held for the taxpayer and refused to exclude from its gross income any of the amounts paid to the contractor.

If the taxpayer in the *Oliver* case was entitled to compute its depletion on the gross proceeds of the sale of ore, without excluding any amounts paid to others, why should not the typical operator, *a fortiori,* be entitled to do the same? If the contractor in the *Oliver* case was thus not entitled to a deduction for depletion, why should the taxpayer here be entitled to depletion? The contractor here has no exclusive possession of the coal site, but it appears that the contractor in the *Oliver* case had much larger rights of control, although as agent only. The contractors in both cases were compensated at a flat rate, and had nothing which could be considered as an "in ore" payment. The contractors in both cases were compensated in relation to *their costs,* and not by reference to the sale price of the coal. The contractor in the *Oliver* case could not sell coal for its own account, and in the case at bar cannot sell coal at all. The contractor in the *Oliver* case had wide powers of management, and if this were a controlling factor, the *Oliver* case (though certainly not the case of the ordinary strip-

ping contractor, with his very limited control) might well have followed the *North Range* and *Eastern Coal* cases, *supra.* The contractor in the *Oliver* case derived his income from the extraction of the ore; he dug it up and handled it as much as or more than the ordinary stripping contractor and as much as the taxpayer here; but that circumstance was not controlling either. It might be said that the contractor in the *Oliver* case was an "agent" of the operator and that therefore his status should be different from that of an "independent contractor". But in an area where the distinctions of legal title have been held not to be controlling, we submit that the distinctions between "employees", "agents", and "independent contractors", important as they may be in the law of torts and elsewhere, are not controlling either. The factor basically distinguishing the *Oliver* case, and with it the case at bar, from the *North Range* and *Eastern Coal* cases, is that in *Oliver,* as well as in the case at bar, the contractors had no right to the *natural resource itself;* in both cases they were hirelings, engaged to perform a service on behalf of another, and were paid a flat sum for those services; but they never took any of the resource for their own account, and thus never had the risks or the chance of profit of those whose interests were inextricably tied up with the mineral deposit. If the purpose of the statute itself, and all the teaching of the Supreme Court and other cases which have worked out its meaning, are to be duly respected here, they must lead to this very emphasis on an interest to exploit, and not merely to dig and haul, the raw material in place. And it is because the typical operator has that interest, and the contractor in the case at bar does not, that the contractor here should not be entitled to a deduction for depletion.

The Commissioner's Ruling on the Question Involved.

G. C. M. 26,290 (1950-1 C. B. 42) deals with the problem whether stripping contractors have "a depletable economic interest in the mineral in place." After a brief

general statement of the reasons why stripping is done through contractors (which statement, incidentally, does not refer to the important fact that such contractors frequently do not receive as compensation any share of the coal produced), the ruling proceeds to summarize the principles developed in the leading cases, correctly emphasizing that "it is enough if the taxpayer has retained a right to share in the mineral produced." The ruling quotes language from *Eastern Coal Corporation v. Yoke, supra,* indicating that depletion may be divided among "investors who, by contractual arrangements between themselves, *agree to divide* the resulting oil or mineral product or the proceeds from the sale of such product."

The ruling, however, then draws from the *Eastern Coal* case an inference which, when taken from its context in that case, leads to conclusions directly contrary to the principles developed in the leading cases and to the holdings in numerous other cases. "The position was taken by the court", the ruling says of the *Eastern Coal* decision, "that the *right of a contractor to a specified amount per ton* of mineral produced may constitute a right to share in production which marks ownership of a depletable economic interest in the mineral in place" (emphasis added). In the *Eastern Coal* case, it is true, the "contractor" received a specified amount per ton for a part of the production sold to Ford; but the "contractor" also received full control over the mine, a fixed plant for which it paid $1,235,000, the right to sell to vendees of its choosing one-eighth of the production—all under arrangements which the court held were indistinguishable from the "contractor's" previous status as lessee, a status which concededly entitled it to depletion. This is a far cry from a holding that a true contractor, with none of the lessee's rights, and no right to share in coal in kind nor to control the sale of any coal—who indeed is paid for his services whether the coal is sold or not—has a "right to share in production" merely because his compensation, for reasons of convenience, is

measured by the quantity of the operator's raw coal material which he hauls to the operator's breaker. That the right to a specified amount per ton does not entitle the recipient to depletion is amply shown by *Anderson,* 310 U. S. 404 (1940), and by *Roeser & Pendleton* and *Oliver, supra,* in all of which depletion was denied to one who received a specified amount by reference to the quantity of oil or mineral produced. The compensation of the railroad which hauls the processed coal from the tipple is determined by reference to the quantity of coal produced and sold for railway shipment; does the railroad therefore have a right to share in the production sufficient to give it a depletable interest? The workman mining underground, whether as employee, or as "contract miner", is often paid by the ton of the operator's coal he brings to the surface; is he therefore entitled to depletion?

The ruling then holds without further discussion that, "dependent on their rights in respect of the properties involved", the stripping contractors are entitled to depletion. If the stripping contract may be terminated by the operator on short notice and without damages, the ruling correctly concludes that the contractor would not be entitled to depletion. There would be no objection to the ruling if it also held that the contractor would not be entitled to depletion under certain other circumstances—for example, where the contractor has no share in the coal produced, or no share in the proceeds of the sale of coal. But if the ruling holds that the possibility of having his contract terminated on short notice is the only factor which would deny depletion to a stripping contractor engaged to strip and load the operator's coal, then the ruling is flatly contrary to the law as it has developed in the cases above discussed.

It may well be doubted whether the ruling was intended to have any such broad and unprecedented construction. Although in its third paragraph, in paraphrasing Section 23(m)-1 of the Regulations, the ruling refers to income derived from "extraction" of the mineral, rather than

to income derived from "severance and sale" of the mineral (as the Regulations, much more consistently with the decided cases, provide), nevertheless, in its sixth paragraph and several times in its ninth paragraph the ruling refers to "severance and sale" or "extraction and sale" as the necessary and exclusive source of the contractor's compensation if he is to deduct depletion. But as we have seen, the contractor in this proceeding does not derive his compensation "from the extraction and sale of the coal", as he does not sell or have any right to sell coal and his compensation depends on rendering services, regardless of whether coal is sold or not. Accordingly it seems probable that the true construction and intent of G. C. M. 26,290 is to deny the depletion deduction to Usibelli, regardless of whether his contract could be terminated without damages. The contrary construction would be fundamentally inconsistent with the principles and holdings of the court decisions in this field.

A Holding That the Contractor in This Case Is Entitled to Depletion Would Not Only Be Contrary to the Congressional Intent and to the Decided Cases, But Would Also Result in Extending Depletion to Many Taxpayers for Whom It Was Never Intended.

The original purpose of Congress in allowing the depletion deduction was to restore to the owner of the coal in place the value of his interest in it. By changing the basis of the deduction from the original cost to 5% of the "gross income from mining" the coal, the purpose of Congress was to encourage the discovery and recovery of coal deposits.

Neither the typical stripping contractor nor the contractor in the case at bar has any proprietary interest in the coal in place which will be depleted as the coal is removed. Nor does he have any part in the discovery of the deposit. He is merely hired by the owner of the coal to dig it out for him. Nor would a depletion allowance to such

contractors stimulate the discovery or opening of new coal mines.

Acceptance of the taxpayer's position here would result in a complete subversion of the purpose and policy of the statutory provision. It would extend the deduction to a host of contractors for whom it was manifestly never intended.

For example, many mine operators engage individuals as "contract miners" to recover the raw coal from a section of the underground mine. Sometimes the contract miners are paid by the hour; often, and more conveniently, they are paid by the quantity of raw coal material produced. These contractors typically furnish their own light tools, and can readily move from one operator's mine to another. Was it ever intended that the deduction for percentage depletion—the means of recovering the taxpayer's interest in the coal in place—should be shared with all these pick-and-shovel contract miners?

What about the contract truckers, who are often engaged to haul the operator's raw coal material to the operator's breaker from his more distant mine openings? They are paid by the quantity of material hauled; they are interested in the sale of the coal in the sense, but only in the sense, that unless the operator sells enough coal to stay in business they will have to render their trucking services to someone else. Are they to be entitled to depletion?

What about the utility whose branch line was built especially to serve the operator's mine? What about the railway whose spur leads only to the breaker? They have invested heavily in the expectation of profit from the coal deposit. In a sense they, too, derive their income solely from the extraction and sale of the coal, but only in the sense that unless the operator continues in *his* business of mining and marketing coal, *their* investment will be lost. They may compute deductible *depreciation* by reference to the exhaustion of the deposit, and if the mine should be exhausted prematurely, they might have a deductible loss

on abandonment. But is their interest in the coal sufficient to entitle them to deduct depletion as well?

What about contractors hired to drive underground tunnels through rock, so as to gain access to remote coal deposits? What about contractors hired to lay railroad tracks in the mine, or to install timbers? These and many other independent contractors depend ultimately for their profit on the severance and sale of the coal, but it has never been suggested that they are entitled to a depletion allowance. Like these other contractors, the taxpayer in the case at bar got, by his contract, not an economic interest in the coal in place, but merely an economic advantage from a contractual relation with the owner of the deposit.

If the depletion deduction is to be kept within the Congressional purpose, if it is to be allowed in a manner consistent with the principles developed in the decided cases, then the deduction must be limited to those who are actually carrying on the mining business, as evidenced by their interest in the coal itself, and their right to share, for their own account, in the proceeds from its sale. This the contractor in the case at bar, like the typical stripping contractor, does not have. Accordingly, the taxpayer here should not be entitled to a deduction for percentage depletion.

The decision of the Tax Court was, therefore, correct and should be affirmed.

Respectfully submitted,

John W. Bodine,
Counsel for Jeddo-Highland Coal Company and the Anthracite Institute.

Of Counsel:

Drinker Biddle & Reath,
117 S. 17th Street,
Philadelphia 3, Pa.